Figure 38.3

After Open Market Operations Are Finished

	Assets			Liabilities	
		The Fed			
1	Treasury securities *(–$5)*	*$78*	*$21*	Reserve accounts of banks *(–$5)*	6
			$57	Federal Reserve notes	
		Banks			
5	Reserve accounts *(–$5)*	*$21*	*250*	Checkable deposits *(–$50)*	4
	Federal Reserve notes	*$4*			
7	Loans *(–45)*	*$360*	$135	Net worth (to stockholders)	
		Bank Customers			
3	Checkable deposits *(- $50)*	*$250*	*$360*	Loans *(–$45)*	8
	Federal Reserve notes	$53			
2	Treasury securities *(+ $5)*	*$57*			

Money supply = *$303 ($250 + $53)*

The following explanation explains what happens when the FED tries to reduce the money supply. This example assumes you START with the chart that is on page 144 and make the following manipulations:

1. Here, the FED wishes to LOWER the money supply. That means they have to be willing to SELL securities. They sell them from their assets (duh, where else would they get them?). The reason they sell $5, is because they want to lower the money supply by $50 and they know that whatever they do will have an effect 10 times larger because of the multiplier.

2. Who do they sell the $5 in securities too? The people in the open market. Now, they have $5 MORE in securities than they did before.

3. Why -$50? Because when that person who bought the $5 treasury bond gave his $5 to the FED, he took it out of the bank, therefore depriving them of making any loans on that money. This is the opposite of the money creation process. Over time, $50 will leave the banking system.

4. If I subtract $50 over time from customer deposits, that is $50 less banks are liable for.

5. If banks are liable for $50 less of deposits, their required reserves can be reduced by 10% of that, or $5 in this case.
6. If the bank reserve accounts are $5 less, then the FED can hold $5 less!

7. Since the banks are out $50, it must mean less loans can be given. How much less? 90%. Why 90? Because the other 10% comes from the required reserve balance that is now less.

8. Customers will receive fewer loans over time, the same amount that banks must cut back on.